Provision of finance to smaller quoted companies: some evidence from survey responses and liaison meetings

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This article reports on some recent work by the Bank aimed at improving our knowledge of the smaller quoted companies (SQCs) sector. This has taken two forms: first, analysis of the results of a questionnaire survey of SQCs drawn from a sample of CBI members; and second, a series of liaison meetings with selected companies outside the sample. Our inquiries suggest that, by reasons of their size, SQCs do not generally have access to bond markets, and that banks are less willing to extend them long-term loans, except on a secured basis. However, we found no evidence of any general problem with access to debt finance. A large majority of firms are able to achieve desired levels of gearing and use a wide variety of debt instruments and derivative products.

For some years, the Bank, working with the Government and private sector financial institutions, has played a prominent role in initiatives to improve the provision of finance to small and medium-sized enterprises (SMEs).(1) SMEs (typically firms employing fewer than 250 people with a balance sheet of less than about £5 million) are almost invariably private companies. But there is another important group of small enterprises comprising *quoted* companies. We have taken as our definition of smaller quoted companies (SQCs) those firms that are below the market capitalisation of the FTSE 350 index but either have a full listing on the London Stock Exchange, or are quoted on the Alternative Investment Market (AIM), or on a non-regulated investment exchange such as OFEX. Table A gives some comparative statistics for the major sub-groups of SQCs. On these data (which do not include OFEX companies), SQCs accounted for 5% of the total market capitalisation of all quoted companies but 13% of their total sales and 18% of total employment.

In the past three years, several working groups, sponsored by both government and private sector organisations, have considered ways of improving the environment for smaller quoted companies. The main focus of their reports has been on factors affecting the ability of SQCs to raise equity capital.(2) But debt finance is also used widely by SQCs and there is some suggestion in aggregate data that the use of debt by SQCs has diverged from that of larger firms in the recent past. Chart 1 shows gross capital gearing for the median firm among the largest 350 companies, and the corresponding gearing of the median SQC.(3) Until about eight years ago, gearing of the representative SQC was not markedly different from that of a representative larger firm. But since about 1996, gearing of large companies has increased quite sharply, while SQC gearing has remained relatively stable. Figures for 2000

Table A
Comparative statistics of larger and smaller quoted companies(a)

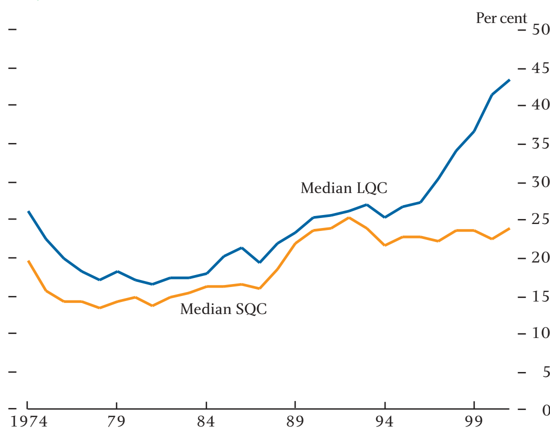
Index	Number of members (b)	Total market capitalisation £ billion (b)	Average market cap. £ billion (b)	Average employment (c)	Average sales £ million (c)
FTSE 350	354	1,420.0	4.01	21,224	2,990.8
FTSE SmallCap	371	50.0	0.13	2,544	260.7
FTSE Fledgling	641	14.6	0.02	763	67.6
FTSE AIM	598	10.5	0.02	289	19.2

Sources: Bloomberg, Thomson Financial Datastream and Bank of England.

(a) The London Stock Exchange in its report, *A statistical analysis of smaller companies on the London Stock Exchange 2000*, defines smaller companies as those outside the FTSE 350 (ie companies in the FTSE SmallCap and Fledgling indices and companies quoted on AIM).
(b) Data as at 28 February 2002.
(c) Data as at end-2001 accounts (2000 year-end accounts if 2001 accounts not yet released).

(1) This work is summarised in a series of annual reports, *Finance for Small Firms*, available on the Bank's web site at www.bankofengland.co.uk/fin4sm08.pdf
(2) See, for example, *Smaller quoted companies: a report to the Paymaster General*, ('Riches Report') HM Treasury (1998); *Improving share liquidity for smaller quoted companies*, ('Waterstone Report') DTI (1999); *A bigger share: encouraging growth in smaller quoted companies*, CBI (2001).
(3) Charts 1–3 are based on data sourced from the company accounts of all quoted non-financial companies held on the Thomson Financial Datastream database (1974–2001 for Chart 1 and 1974–2000 for Charts 2 and 3). (The share of bank finance in all debt is available only from 1983 onwards.) LQCs are defined as the top 350 companies ranked by market value in each year. SQCs are defined as those outside the top 350 by market value. The median rather than the average value of each variable is presented because the distribution of each variable is skewed. We interpret the median firm as a representative smaller or larger quoted company.

Chart 1
Capital gearing of the median SQC and LQC(a)(b)



Sources: Thomson Financial Datastream and Bank of England.

(a) Defined as gross debt divided by capital stock at replacement cost.
(b) 2001 data are provisional and based on 622 company accounts.

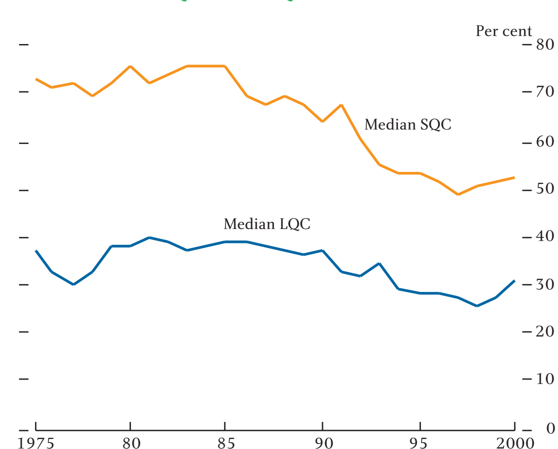
on 927 SQCs and 350 larger companies show that the level of capital gearing of the median SQC is 22.4%, compared with 41.6% for the median larger quoted company (LQC). This raises the question of whether SQCs have recently experienced constraints on the overall supply of debt finance.

Charts 2 and 3 show some further comparisons between the debt positions of smaller and larger companies. Chart 2 shows the share of debt with a residual maturity of less than one year. Although reliance on short-term debt has fallen compared with the early 1980s, it still accounts for more than half of total debt for the median SQC, compared with about 30% for the median LQC.

Chart 3 shows the share of all debt sourced from banks for the median smaller and larger quoted company. The data suggest that while LQCs have diversified into non-bank sources of debt, SQCs by comparison remain relatively more reliant on bank-sourced debt. Figures based on year-end company accounts for 2000 show that the median SQC obtained 78% of all debt finance from banks. This represents a modest reduction compared with the early 1980s, when the median SQC obtained more than 90% of its debt from banks. However, over the same period LQCs have diversified their debt financing to a greater degree, so that the share of bank debt for the median LQC has fallen from a peak of 75% in 1985 to 48% by end-2000.

In an attempt to explore what might lie behind these aggregate trends, the Bank conducted a questionnaire survey of SQCs drawn from a sample of CBI members.

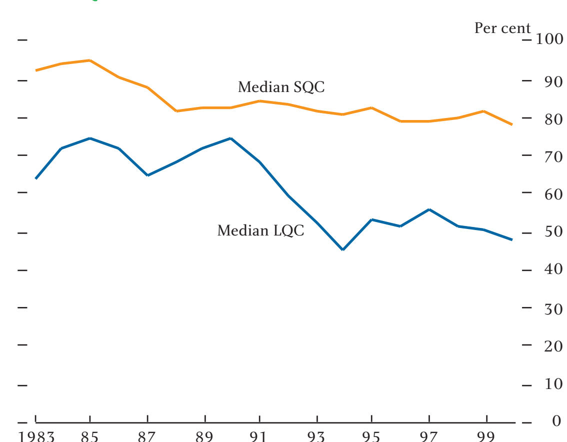
Chart 2
Share of gross debt due within one year for the median SQC and LQC(a)(b)



Sources: Thomson Financial Datastream and Bank of England.

(a) Defined as gross debt due within one year divided by total gross debt.
(b) Data are to year-end 2000.

Chart 3
Share of bank debt for the median SQC and LQC(a)(b)



Sources: Thomson Financial Datastream and Bank of England.

(a) Defined as bank debt divided by total gross debt.
(b) Data are to year-end 2000.

This was followed by a series of liaison meetings with selected SQCs outside the sample. The questionnaire focused on debt finance and sought to establish the extent to which SQCs across a range of sectors are able to achieve target levels of gearing, a desired maturity profile, and a balance between fixed and floating-rate debt. We also investigated the role of different debt instruments in achieving these targets. Where firms were not making use of particular types of debt finance, our interest was in knowing whether this was the result of an unfavourable cost trade-off or because of factors, unrelated to price, affecting the willingness to borrow or lend. The liaison round ranged more widely and also sought to uncover evidence relating to the supply of equity finance to SQCs.

Survey of CBI members

The survey results are based on 50 replies received to a questionnaire on debt finance distributed on the Bank's behalf by the CBI in May 2001 to 300 of their SQC[1] members. The average number of employees in our sample of respondents was 3,801, with an average turnover (in 2000) of £440 million. A comparison of the estimates of average sales and employment in our sample with those presented in Table A shows that our sample representative firm is larger than the average FTSE SmallCap quoted company. The responses came from firms covering a wide range of sectors, including construction, retailing, engineering, metal manufacture, food manufacture, distribution, healthcare and pharmaceuticals.[2] However, the small overall size of the sample should be borne in mind, especially given that in places the questions sub-divided the respondents. A number of respondents included comments that were helpful in interpreting their responses to the formal questions. The survey investigated three issues: the aggregate level of company borrowing and its composition by maturity; factors affecting the use of individual types of debt instrument; and the nature of the company's relationship with its bank(s).

Overall debt and gearing levels

The survey responses suggested that gearing levels for this sample of SQCs are high by historical standards and are not constrained by the availability or expense of debt finance. The median level of gearing in the sample was 30% (with a range of 0% to 181%). This is higher than the gearing of the median SQC (see Chart 1). Some 49% of respondents indicated that their level of gearing was high by historical standards, 20% average and 31% low.

Around 42% of companies said that they had a target gearing level. In cases where current gearing levels were lower than target, respondents were explicitly asked whether this was because debt was unavailable or too expensive. Only about 10% of firms with gearing below target said that these factors were responsible. Of the firms whose gearing was constrained by the *supply* of funds, most attributed this to weak financial performance, particularly operating losses. Two technology-based companies said that their access to bank finance was constrained by a lack of tangible assets. Another firm in the construction sector explained that a large part of its bank credit limit was used up by contract performance bonds.

But in general, gearing appeared to be determined by non-price-related factors constraining the *demand* for funds. Comments accompanying the responses suggested that a number of firms could potentially increase their debt levels but chose to adopt a more conservative level of gearing. Some firms indicated that their financing structure reflected a high degree of risk aversion. Some had a policy of normally financing capital investment out of retained earnings. Several firms indicated that they would be willing, at least temporarily, to increase gearing for acquisitions but at the time of the survey did not have a target. The lack of a suitable acquisition was the factor most frequently cited as limiting the demand by firms for debt finance.

Individual sources of debt finance

Companies were questioned in greater depth on their sources of finance. The responses suggest that overdrafts, short-term loans, leasing, letters of credit and interest rate swaps were the most commonly used instruments. Longer-term loans, secured lending, commercial bills and commercial paper, bonds, factoring and invoice discounting were less widely used.

Sterling bank finance

Overdraft financing was still the most commonly used instrument, with almost 90% of respondents currently using a facility. Term loans of up to five years (by original maturity) were used by more than half the respondents—but longer-maturity loans were much less common. More than two-thirds of the sample had never borrowed for longer than five years.

The absence of long-term lending does appear in part to be a supply constraint. Two-fifths of respondents claimed that loans for longer than five years were unavailable and there was some indication (in a small sample) that long-term loans were regarded as too expensive. However, an equal proportion cited factors other than cost and availability as reasons for the absence of long-term borrowing. Comments suggest that in the current interest rate environment, firms are

(1) Defined as above, ie quoted companies outside the FTSE 350 index. Our sample included AIM companies as well as those officially listed.
(2) The questionnaire and liaison meetings combined included firms in just under half of the approximately 30 two-digit SIC industrial groups.

less worried about renegotiating their borrowing at relatively frequent intervals. Indeed, some respondents said that they regarded longer-term commitments as reducing flexibility. Some firms indicated that they did not have long-term assets to match long-term borrowing.

Slightly less than half the respondents had loans secured on property or other fixed assets. Here again, where secured lending was absent it appeared to be the choice of borrowers. Only one of the seven respondents to the question on why they did not have secured loans said that secured lending was unavailable, their comment suggesting that this was the result of an absence of fixed assets on which to secure loans. Other comments suggested a general aversion to secured borrowing, which was thought to restrict business options. The small size of the sample respondents should, however, be borne in mind.

Table B
Sterling bank finance

Per cent of respondents responding in each category

Facility	Currently use	Have never used	Would not expect to use	*Number of respondents*
Overdraft	89	9	2	*47*
Term loan less than one year	55	30	15	*33*
Term loan 1–5 years	67	25	8	*36*
Term loan 6–10 years	19	68	14	*37*
Term loan more than 10 years	3	83	14	*35*
Secured on commercial property	39	42	19	*36*
Secured on other fixed assets	42	42	17	*36*

Foreign currency bank finance

The respondents divided clearly into those that actively used foreign currency facilities and those that never did. Perhaps surprisingly, as many as a third of respondents currently had foreign currency term loans. As with sterling loans, these were mostly for five years or less. Again, there is some evidence of a lack of willingness by banks to lend at longer maturities (a third of respondents reported loans unavailable) but demand factors appear to be more important.

Table C
Foreign currency bank finance

Per cent of respondents responding in each category

Facility	Currently use	Have never used	Would not expect to use	*Number of respondents*
Overdraft	55	38	7	*42*
Term loan less than one year	31	59	10	*39*
Term loan 1–5 years	30	63	7	*43*
Term loan 6–10 years	5	87	8	*38*
Term loan more than 10 years	5	87	8	*39*
Secured on commercial property	19	67	14	*43*
Secured on other fixed assets	17	68	15	*41*

Other debt instruments

In contrast to the relatively wide use of foreign currency borrowing, only a small proportion of firms raised funds through issue of debt securities. Once again firms were mainly current users of these instruments or not users at all. At both short and long maturities, traditional instruments were more commonly encountered; users of commercial bills and (secured) debentures outnumbered users of commercial paper and unsecured bonds by a factor of about three to one.

There was somewhat stronger evidence of a lack of supply of funds in this area—but only in the case of bonds was unavailability the main determining factor. From the respondents' comments, the main reasons why funds were unavailable included the (small) size of company and absence of a formal credit rating.

Table D
Other debt instruments

Per cent of respondents responding in each category

Facility	Currently use	Have never used	Would not expect to use	*Number of respondents*
Commercial bills	29	66	5	*41*
Commercial paper	8	83	8	*36*
Debenture stock	24	73	3	*33*
Bonds (unsecured)	9	89	3	*35*

Asset-based financing

Asset-based financing, particularly leasing and hire purchase, was widely used among the sample. Indeed, operating leasing ranked with sterling overdraft financing as the most commonly used instrument of all. This left a very small number of firms to answer the question on why they did not use leasing. None claimed that leasing or hire purchase was unavailable. A majority of non-users of leasing said that it was too expensive. Hire purchase was thought by half of the firms to be expensive and described by one respondent as 'too restrictive'.

Table E
Asset-based financing

Per cent of respondents responding in each category

Facility	Currently use	Have never used	Would not expect to use	*Number of respondents*
Finance leasing	82	7	11	*44*
Operating leasing	87	9	4	*46*
Hire purchase	65	27	8	*37*

Receivables financing

Turning to receivables financing, there was a marked contrast between the response on letters of credit and on

factoring and discounting.[1] Letters of credit were used by just over half the respondents. This is an almost identical proportion to those using foreign currency overdrafts, which is perhaps not surprising given the role of both in export finance. Factoring and invoice discounting, however, was used by less than one in six of the respondents. This appears to be mainly a matter of cost but the comments indicate that some firms see factoring as unattractive for other reasons. One firm commented that to use it could signal to the market that a company had liquidity problems, a view echoed by some firms in the liaison meetings. Aggregate statistics indicate, however, that funds raised through factoring and invoice discounting have risen quite rapidly in recent years for privately-owned SMEs, albeit from a low base.[2] This could reflect the fact that SMEs have fewer alternative sources of finance and also face greater difficulties collecting debts than SQCs.

Table F
Receivables financing

Per cent of respondents responding in each category

Facility	Currently use	Have never used	Would not expect to use	*Number of respondents*
Factoring	15	50	35	*41*
Invoice discounting	10	56	33	*40*
Letters of credit	56	36	8	*39*

Other financial instruments

Almost half the respondents used either interest rate or foreign currency swaps. Of the non-users, only a small number claimed that swaps were unavailable to them. The responses suggest that availability was not significantly worse for currency swaps than for interest rate swaps but this again is on the basis of a very small sample. Cost was an issue for a somewhat larger number of firms but once again other factors were more important. In the case of foreign currency swaps, the main reason for non-usage was simply an absence of foreign currency exposure. In the case of interest rate swaps, some firms felt more relaxed about floating-rate debt in the present economic climate.

Table G
Other financial instruments

Per cent of respondents responding in each category

Facility	Currently use	Have never used	Would not expect to use	*Number of respondents*
Foreign currency swap	42	49	9	*43*
Interest rate swap	52	43	5	*44*

Fixed and floating-rate debt

The survey suggests that SQCs currently rely more heavily on floating-rate debt than on fixed-rate debt. The average percentage of company debt that was fixed in our sample was 34% (with a range of 0% to 100%). About one-fifth of our sample had in excess of 75% fixed-rate debt but nearly half of the sample had less than 25% fixed-rate debt. For half the sample, the proportion of fixed-rate debt is average by historical standards, while the remaining half is roughly equally divided between firms for whom the proportion of fixed-rate debt is high by historical standards and those for whom it is low.

Some 35% of respondents had a target ratio of fixed to floating-rate debt. Two-thirds of these companies were at their target levels while about one-third were below their target levels. None of these companies said that the proportion of fixed-rate debt was too low because fixed-rate debt was unavailable. However, the explanatory comments suggested that fixed-rate debt might be regarded as expensive, in the sense that long-term interest rates exceeded the firms' expectations of the average level of future floating rates over the relevant maturity.

There were also respondents who said that their use of debt related to working capital needs and was of its nature very short term. Another respondent operated in a market with a regulatory regime based on '*k*' plus RPI, giving an element of natural hedge to floating-rate debt.

Bank relationships

On average, respondents had relationships with four banks. The minimum number was one and the maximum twelve. The average time a company had spent with the most-used bank was 28 years. Four had used the same bank for more than 100 years. However, some 28% of the sample had been with the most-used bank for less than ten years and more than a fifth of firms had changed banks recently.

One of the firms changing banks recently said that current facilities were uncompetitive while two said that facilities were no longer available at their current bank. A large majority of firms indicated that their likelihood

(1) Factoring involves the purchase of book debts due to a company, together with management of its sales ledger and the collection of accounts under the terms agreed by the seller. The factor may assume the credit risk for accounts within the agreed limits (non-recourse), or this risk may be retained by the seller. Invoice discounting involves the purchase of book debts but with the sales accounting functions retained by the company and the facility usually provided on a confidential basis.
(2) This work is summarised in a series of annual reports, *Finance for Small Firms*, available on the Bank's web site at www.bankofengland.co.uk/fin4sm08.pdf

of moving bank would be increased if current facilities became uncompetitive relative to other banks, if facilities were no longer available at their bank, and/or if existing facilities could only be maintained by moving bank. Other reasons given for actually or potentially changing bank included a need for more international coverage, a concern to maintain active communication with the relationship bank, or takeover by another bank.

Some companies had enlarged their banking group because of a need for additional funds or because of a desire to diversify their funding sources. Some firms had slimmed down their banking group so as to concentrate their ancillary business on a smaller core group.

Some 90% of respondents said that their main bank understood their business sufficiently well to make reasoned decisions on credit, while 80% believed that banks had improved in this area over time.

Liaison meetings with SQCs

Following the survey, the Bank conducted liaison meetings with about 30 SQCs, mainly in the fourth quarter of last year. Within the limitations of this number we attempted to get a degree of variation by size, sector, age of company and geographical distribution. The sample included firms with market capitalisation as low as £5 million and as high as £250 million. Their activities included food manufacture, metal and vehicle manufacture, biopharmaceuticals, support services, retailing, entertainment and leisure. These meetings corroborated the findings of the survey in a number of ways. As a generalisation, most firms had few concerns about their ability to access debt finance.

Overall debt and gearing levels

Larger SQCs (with turnover of, say, more than £100 million) said that their gearing was determined more by shareholder preference, financial prudence or the nature of the firm's business than by any constraint on the supply of funds. Not surprisingly, the more highly-geared firms tended to be those that had substantial fixed assets and that made greater use of secured lending. One firm, with very high levels of gearing through debt secured on fixed assets, said that private companies with which it competed operated with higher gearing levels than would be acceptable to its own shareholders.

Most of the larger companies also borrowed on an unsecured basis. Several firms had used bank borrowing for acquisitions. A number of the larger companies had borrowed in the syndicated loan market, either in the form of term loans or revolving facilities. Most borrowing was for up to five years but firms willing to offer security and accept a relatively restrictive covenant package could borrow for longer periods.

Some firms with tangible assets on which debt could be secured had issued sterling debentures. The strong security and restrictive covenant package in debentures enabled firms to borrow for maturities of around 25 years. However, in the present interest rate environment, firms saw shorter-maturity unsecured debt as more attractive. None of the firms had issued eurobonds (because they were too small or lacked a rating), but two had accessed the US private placement market. In most cases firms achieved the desired balance between fixed and floating-rate debt through use of interest rate swaps.

Smaller firms, not surprisingly, were more likely to be single-banked. They borrowed mainly for working capital purposes using overdraft or revolving facilities.

Other debt instruments

A number of firms made use of leasing, although perhaps a smaller proportion than in the survey sample. But firms that used leasing did so extensively.

Receivables financing was not relevant to some of the firms (such as the retailers) because they had no trade creditors. There was again something of an aversion to factoring, which was regarded variously as expensive, entailing an unacceptable loss of control over the sales process, or signalling to the market that the firm had liquidity problems.

Bank relationships

Firms appeared to attach considerable importance to their bank relationships. Most felt that the banks understood their business. A number clearly made an active effort to inform their banks (for example supplying management accounts and forecasts). One firm said that it had changed its lead bank because a merger had resulted in the replacement of bankers with expertise in their sector. Another had switched because a merger had taken away local senior management.

There seemed to be a convergence in the size of banking groups towards around three to six banks. Firms that had large groups (usually as a result of an oversubscribed syndication) were generally seeking to

reduce this coverage. This was partly because the administrative effort of dealing with so many institutions was too great, and partly because they had too little ancillary business to share out among this number of banks. Firms that had previously been single-banked wanted to diversify their sources of funding and force the banks to become more price-competitive.

Some firms had sought to develop relations with foreign banks as part of an effort to expand internationally. One firm had acquired and maintained a relationship with an overseas (European) bank as a result of its takeover of a local business. Another had extended its banking group to foreign banks in the belief that this would help to develop business in the banks' domestic market.

Equity finance

In our meetings, we also raised the question of access to equity finance. Only a minority of companies had recently raised new equity. These tended to be in two groups. First, larger companies (with a market capitalisation of, say, above £200 million), whose shares were more likely to be held by institutional investors. These companies had raised funds in amounts of £30 million–£50 million, through both rights issues and institutional placings. The second group consisted of AIM companies, some of which had returned to the market to raise cash, typically in amounts of less than £10 million.(1)

However, a significant proportion of firms saw no prospect of raising new equity. Family ownership appeared to discourage raising additional equity capital, through internal opposition to dilution.

Even the larger firms said that the secondary market for their shares was highly illiquid, with only a small number of dealers quoting prices, with wide bid-offer spreads and large day-to-day price movements. Some of these firms attributed the lack of liquidity fundamentally to institutional investors' preferences for larger corporates at the FTSE 350 level. It was interesting nevertheless that there were two AIM companies in our sample that had each succeeded in attracting several thousand individual investors. Their shares traded on narrow spreads in relatively large overall volume.

In interpreting these findings on equity finance, it is difficult to distinguish cyclical from structural factors. The liaison meetings took place during a period of particular weakness in equity markets, so it is hardly surprising that many firms were at that time finding equity markets a less important source of finance than bank finance. But many SQCs gave the impression that a listing had been sought partly to improve their longer-term access to debt rather than equity finance.

How representative are these findings?

We are conscious that both these exercises have sampled only a tiny proportion of the universe of SQCs, and in the case of the survey some questions received only a partial response. One source of comfort is that the results are similar to those of the annual survey on the provision of finance to member firms conducted for the Institute of Directors.(2) That report concluded, *inter alia*, that bank overdrafts and loans are the most common forms of external finance for SMEs, the majority of loans are under five years' duration, and the vast majority of firms have a good relationship with their bank. Perhaps the most likely source of bias in both the survey respondents and the firms interviewed is that they failed to pick up the weakest and/or smallest companies. However, preliminary analysis shows that although the SQCs in our sample are on average larger and more profitable relative to the average SQC, the only *statistically significant* difference is size.

Summary

The results of the survey and the liaison meetings were broadly corroborative. By reasons of their size, SQCs do not generally have access to bond markets and there is some suggestion that banks are less willing to extend them long-term loans, except on a secured basis. However, we found no evidence of any general problem with access to debt finance. A large majority of firms are able to achieve desired levels of gearing and use a wide variety of debt instruments and derivative products. Banking relationships are generally highly valued and a majority of firms considers that banks have improved their understanding of the needs of businesses. Difficulties are, however, encountered in raising equity finance, reflecting both the particular weakness of equity markets during the period of the liaison meetings and longer-term structural factors associated with lack of liquidity in smaller company stocks.

(1) Six of the nine companies in our group that had come to the market since 1995 had done so via AIM. Most cited tax advantages as the main reason for choosing this route.
(2) See Wilson, R (2002), 'Business finance', *IoD Policy Paper*.